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[REDACTED]: Aviation Fuel Sales

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This is in response to your memo dated October 22, 1990, in which you asked whether any part of the income earned by [REDACTED] and [REDACTED] can be recharacterized as service income under section 861(a)(3) of the 1954 Income Tax Code. On April 11, 1991, we sent you a memo with a preliminary discussion of the case law in the subject area. In addition, we asked for more information to assess the chances of prevailing with a services argument.

We have reviewed the information you sent on June 11, 1991, in response to our request. In our opinion, the facts of the case are not sufficiently favorable to convince a court that the income earned by [REDACTED] and [REDACTED] is from the performance of services rather than from the sale of goods. As was stated in our April 11, 1991 memo, to argue that the income earned by the two corporations is from the performance of services rather than from the sale of personal property, it is first necessary to prove that neither [REDACTED] nor [REDACTED] "owned," for tax purposes, the jet fuel they claim to have sold. Although [REDACTED] and [REDACTED] lacked certain elements of ownership, [REDACTED] and [REDACTED] seem to have had those elements of ownership the courts consider most important.

The facts of the case, as related by the taxpayer and as we understand them, are summarized below. [REDACTED]

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(██████████), a domestic corporation, wholly owns ██████████ (██████████), also a domestic corporation. ██████████ also indirectly owns ██████████ (██████████), a U.K. corporation. (For this memorandum, we will refer only to ██████████, although the discussion applies equally to ██████████). ██████████ marketed aviation fuel by securing aviation fuel sale contracts with various unrelated airline companies throughout the world except in the United States. Sales of jet fuel in the U.S. were conducted by ██████████ (██████████), a ██████████ subsidiary.

██████████ purchased fuel from related and unrelated local companies at foreign airports. These local operating companies owned the fuel inventory, the hydrant systems, storage tanks, etc. necessary for the supply, storage, and delivery of jet fuel. Until ██████████, ██████████ did not own any such assets, nor did it generally have any presence in the foreign countries.

██████████ acquired title to the jet fuel from a local company at the flange of an aircraft. Immediately thereafter, as the fuel was pumped into the aircraft, ██████████ transferred title to the airline. ██████████ claims that the income earned from the jet fuels contracts was income from the sale of tangible property under section 862(a)(6).

#### FACTUAL REPRESENTATIONS

Taxpayer has stated that ██████████ bore the risk of loss on collection and credit, therefore, it bore the risk of loss in the case of nonpayment by customers. See I/E 238. In cases where ██████████ acted as agent for ██████████, ██████████ incurred risk of collection loss arising from the assignment by ██████████ to ██████████ of ██████████'s receivable. See I/E 240. Assignment of the receivable in cases where ██████████ was ██████████'s agent seems to have been the usual procedure. See IDR Map 3 (██████████ letter from ██████████ to ██████████) and IDR 77/9 260.

During the ██████████ interview of ██████████ (page ██████████), taxpayer stated that "the ██████████ party signing the contract" indemnifies the airline against all legal action claims, damages, losses and expenses which may arise due to breach of contract or negligence. In addition "the ██████████ entity that's signing the contract" warrants to the airline "the compatibility of all commingled products contributed to the product pool," and "protects the airline against the

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infringement by third parties of safety, cleanliness, quality control, product specifications, handling and other requirements."

The risk of physical loss was split between the local operating companies and the customers. The local operating company bore the risk of loss on the fuel up to the point that the fuel passed the delivery flange at which time the title and risk of loss was transferred to ██████. See I/E 238. ██████ then passed title and risk to its customer as the jet fuel passed the loading flange upon entry into the airplanes' fuel tank. Because ██████ did not generally maintain fuel inventories and held title only briefly as fuel passed into the airplanes, ██████ held no insurance on the jet fuel. See I/E 238.

Until 1984, any actions required by the local authorities, including registering to do business, filing reports, etc., were conducted by the local operating companies. To the extent that local sales taxes, duties, etc. were applicable to sales of fuel to airline companies, such taxes were paid by the airline companies. When required, ██████ collected local sales taxes from the airline company and filed them with the appropriate authorities. See I/E 239.

#### ANALYSIS

The sale of inventory goods implicitly involves certain activities, including such marketing services as arranging for purchase from producers and sale to customers. However, unless the taxpayer had no ownership of the goods at issue, all income that is generated by the sale of inventory goods are categorized as sales income, including any income attributable to such services as the solicitation of contracts and other marketing activities. Therefore, in order for the activities of ██████ to generate income that is from the performance of services, the court must conclude that ██████ did not own, at any time, the jet fuel sold to the airlines. By establishing that the facts do not support ██████'s claim of ownership of the jet fuel, we could argue that the income earned by ██████ was from services, i.e., from bringing together the supplier and buyer of the jet fuel, which is analogous to a sales commission.

In the present case, the most persuasive factor showing that ██████ had ownership of the jet fuel is that ██████ bore the risk of credit and collection, i.e., that ██████ bore the risk

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that the customers would not pay.<sup>1</sup> In two recent cases with factual situations very similar to those of the present case, *Epic Metals Corporation and Subsidiaries v. Commissioner*, 48 TCM (CCH) 357 (1984), and *Liggett Group, Inc. v. Commissioner*, 58 TCM (CCH) 1167 (1990), AOD-OM 1810 (Feb. 11, 1991) (copy attached), the Tax Court found significant that the seller bore the risk of nonpayment in the event its customer defaulted. The court found that a sale occurred despite the fact that the seller held title and bore the risk of loss or damage to the goods only momentarily, and that the seller never had physical possession of the inventory goods it sold. The court held that the instantaneous acquisition and disposal of title to the goods was sufficient to transfer "rights, title, and interest" to those goods and thus, constitute a "sale." *Liggett* at 1173.

██████████'s responsibilities to the customer are another factor which is consistent with its ownership of the jet fuel. For example, taxpayer stated that ██████████ was responsible to the airlines for breach of contract or negligence. In addition, taxpayer has stated that the airline looks to the "██████████" affiliate with whom the contract was concluded for any recourse if there is any complaint about the product delivered."<sup>2</sup> See

<sup>1</sup>Although the taxpayer has clearly stated that ██████████ had the risk of collection and credit, the facts are still unclear on how broad that risk was. For example, the taxpayer has stated that "there was no adverse consequence to ██████████ of failing to take agreed supply from a related operating company." See I/E 238. If this statement means that ██████████ had the option of canceling its contract with the local companies to take the fuel should the airline cancel its contract with ██████████, then the risk of economic loss to ██████████ is lessened.

In addition, if the ability to cancel the supply contract without adverse consequences is limited to only those contracts between related operating companies, then such a difference between contracts with related and unrelated local companies raises a section 482 issue, i.e., the price on the related party contracts with the lesser risk due to the cancellation provision should be higher.

<sup>2</sup>Taxpayer made reference to the "██████████" signing the contract and the "contractor." We are assuming that he meant ██████████ and ██████████. If ██████████ is not the "██████████" affiliate to whom the airlines look for breach of contract and product

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IDR 77-9 (262).

The facts discussed above are, under current case law, sufficient to show ownership of jet fuel by ██████ and thus, to lead to the conclusion that the income earned by ██████ is from the sale of such jet fuel to customers. We believe that the factors present in this case are enough to overcome the lack of certain elements of ownership, discussed below.

One area in which it is unclear whether ██████ was the actual owner of the jet fuel is in their representation to the local authorities. In Epic Metals the court took particular note of the fact that the seller's claim that it was not the owner of goods was inconsistent with its own tax treatment of the income earned from the sale of goods, with the fact that it was designated the vendor for state sales tax purposes, and with its representation to its customers that it was the owner of the goods. Epic Metals, 48 TCM 361. It is unclear from the facts whether ██████'s claim to be the sellers of the jet fuel for federal income tax purposes is totally consistent with its representations and actions as sellers in non-federal tax areas. Taxpayer stated that until ██████, any action required by local authorities was conducted by the local companies and that local sales taxes and duties were paid by the airline company. See I/E 239. This statement implies that ██████ did not have any presence in the countries where jet fuel was sold, much less pay any income or sales tax on the sales made in those countries. Such statements are unclear as to whether ██████ had any tax liability in those countries. If ██████ did not have any tax liability, the facts are unclear as to why no tax liability existed. For example, was ██████ exempt from sales tax when it bought jet fuel from the local companies because there was no sales tax on the jet fuel; because it was exempt from sales taxes as a vendor of jet fuel?

One element of ownership which ██████ clearly lacked was the risk of loss from physical damage. ██████ did not have the risk of physical loss of the jet fuel, since the risk of loss was passed directly from the local operating companies to the airlines. Nor did ██████ insure the jet fuel it purportedly sold. While such factors were important in earlier cases to determine when and where title and ownership of goods passed

satisfaction, then there is a much stronger basis for arguing that ██████ is not the owner of the jet fuel.

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from one party to another,<sup>3</sup> recent case law has lessened the conclusive effect given to the presence of such facts.

#### CONCLUSION

Given the current state of the law as set forth in *Epic Metals and Liggett*, we believe it would be difficult to argue that there was no sale of jet fuel to ██████ when ██████ in fact bore the risk of nonpayment should the airlines fail to make payment. The fact that ██████ had no risk of loss from physical damage to the jet fuel might have been important had ██████ also not had such risk of nonpayment. However, given the other factors in the case, the lack of risk of loss from physical damage is not sufficient to prove that there was no sale to and ownership of the jet fuel by ██████. In summary, we believe it is more likely than not that, based on these facts, a court would conclude that there was a sale of jet fuel by ██████ to the airlines, and that ██████'s income is from the sale of that personal property.

Attachment

<sup>3</sup> For example, in *Commissioner v. Pfaudler Inter-American Corporation*, 330 F.2d 471 (2d. Cir. 1964), the court held that title to goods passed from parent to subsidiary when goods were shipped from parent's factory or warehouse, at which time subsidiary obtained title to and control of goods assumed the risk of loss in transit.